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The Impact of Nigeria's New Transfer Pricing Rules on Multinational Enterprises

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Summary

As a developing nation with a wealth of natural resources — including proven oil and gas reserves and significant mineral deposits — Nigeria is enjoying an increasing influx of foreign investment and business activity. As a result of multinational enterprises establishing operations in Nigeria and the increased volume of intercompany transactions — both in terms of the number and the value — between these local affiliates and their foreign counterparts, transfer pricing is a top-of-mind concern for the Federal Inland Revenue Service (FIRS). In an attempt to combat perceived income shifting by foreign taxpayers out of Nigeria, FIRS published new transfer pricing rules on September 21, 2012. These latest rules signal a new level of sophistication of the Nigerian government in terms of addressing international commerce and taxation and reflects the move toward formal transfer pricing rules in other developing nations. Consequently, it is critical for corporate taxpayers and their advisors to educate themselves on the new rules and understand the trends and precedents set by this recent legislation in the context of their own business strategy in the region.

Nigeria's Rise. As a developing country, Nigeria has been recognized by prominent members of the global investment community and economists as an up-and-coming market with tremendous growth potential over the next several decades. A member of the Organization of Petroleum Exporting Countries (OPEC) since 1971, Nigeria ranks as the largest oil producer in Africa and the eleventh largest in the world. The US Energy Information Administration reported Nigeria's proven oil reserves at 37.2 billion barrels as of 2011. In addition to oil and gas, Nigeria has vast underexploited mineral resources including coal, bauxite, gold, and iron ore. The country's natural resources have attracted the attention of the super major oil and gas companies as well as businesses in allied industries including oil field equipment and services, transportation and logistics, and petrochemicals and plastics.

As the seventh most populous country in the world, Nigeria is also rapidly expanding its infrastructure and witnessing foreign and domestic investment from major players in the engineering and construction industry as well as the telecommunications sector. The financial services segment also continues to expand in Nigeria as international banks and investors look to capitalize on the expansion of the West African market.

"Transfer Pricing" Defined. With nearly 70% of all international trade taking place between related parties, according to data published by the United Nations (UN) Conference on Trade and Development, transfer pricing is on the radar in both developed and developing nations alike. Generally transfer pricing refers to the structuring and pricing of transactions between members of the same controlled group. Typically, the concern is with cross-border transactions where income and expenses are allocated among taxpayers in different jurisdictions. However, many countries — including Nigeria — also consider domestic transactions between affiliates.

Transactions between related parties run the gamut from the sales of tangible goods and the licensing or sale of intellectual property to the provision of services and the extension of credit or financing. Virtually every category of transaction effected between third parties occurs between affiliates at one time or another.

Due to the sheer number of intercompany transactions and the belief by many tax authorities that mispriced transfers between related parties may result in the unreasonable shifting of income and expense between jurisdictions when compared to the same transactions conducted between third parties, the attention given to transfer pricing globally has never been greater. Potential transfer pricing abuse is a particular concern of developing nations, like Nigeria, because of the sophistication of the foreign taxpayers and significant amount of money in play. Put simply, developing nations want to retain as much of the profit derived from the exploitation of their resources and other business carried out within their jurisdictions as possible and transfer pricing directly impacts the taxable income in the local jurisdiction.

Nigerian Legislative History. General anti-avoidance rules (GAAR) have been on the books in Nigeria for many years. Specifically, Section 17 of the Personal Income Tax Act (2004), Section 22 of the Companies Income Tax Act (2004, amended 2007), and Section 15 of the Petroleum Profits Tax Act (2004) all provide for the FIRS to adjust any transaction — intercompany or between unrelated parties — which is deemed to produce a result artificially reducing taxable income in Nigeria. Up until this point the rules were largely ineffectual from a practical standpoint, because there was no guidance or framework for enforcing GAAR. Moreover, the lack of guidance resulted in the inconsistent application of the principles of the original legislation and compounded existing perceptions by some taxpayers of FIRS as dysfunctional.

Over the last several years, Nigeria has worked to develop its own transfer pricing rules based on the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) and the commentary surrounding the creation of the UN Transfer Pricing Manual (UN Manual) which was formally approved in October 2012. The FIRS released the draft transfer pricing rules in May 2012, and the final rules in September 2012, as The Income Tax (Transfer Pricing) Regulations No. 1, 2012 (The Regulations).

Compliance with the Arm's Length Principle. The Regulations are grounded in the arm's length principle, which is the cornerstone of nearly all developed transfer pricing regimes worldwide. Under this principle, commonly controlled companies should transact business with their affiliates at arm's length — as if they were unrelated. This foundation is important because it allows taxpayers to base their transfer prices on the facts and circumstances of their intercompany transactions and the associated economic analysis as opposed to prescribing an apportionment or deemed profit approach. Formulary methods sometimes appear more straightforward in terms of application and may in some instances provide for greater certainty for the taxpayer. At the same time, these approaches have their own complexities in terms of which formula should be used and often the result of applying the formula is quite different from what would occur at arm's length — to the benefit of one jurisdiction and the detriment of another.

Taxpayers Impacted. The Regulations are applicable to broad categories of taxpayers defined as persons, individuals, entities, companies, partnerships, joint ventures, permanent establishments, trusts and associations — defined as "*connected taxable persons*" or CTPs — to the extent that one party participates, directly or indirectly, in the management, control, or capital of the other, or where both parties have common control, management, or shareholders. It is noteworthy that there is no specific threshold, such as stock ownership or voting shares, for determining control. As such, a situation could exist where two companies could be deemed as "connected" due to the facts and circumstances of their relationship granting one *effective* control over the other despite having no common ownership. For example, a customer who purchases in excess of 90% of an unrelated manufacturer's output potentially could be seen as effectively controlling the pricing with respect to that manufacturer.

Applicable Transactions. Essentially, any transaction which affects the income or expense of a CTP is subject to the Regulations. In addition to the sale or leasing of tangible goods, applicable transactions include loans and financing, the licensing and sale of intangible property, and the provision of services. Although specific reference is not made to the anti-avoidance provisions in other tax laws — such as the Capital Gains Tax Act (Act No. 44 of 1967, as last amended by Act No. 45 of 1999) — in all likelihood the principles established in the Regulations will be applied in other tax-related matters such as withholding tax and value-added tax (VAT).

Domestic Transactions. As Nigerian rules do not provide for members of the same group to file income taxes on a consolidated basis, taxpayers and their advisors should pay special attention to purely domestic transactions between their Nigerian affiliates. FIRS will likely look for instances where there is a potential for tax revenue loss due to the shifting of income between CTPs with different tax rates or involving a loss-making entity within a profitable group. The Regulations are equally applicable whether the controlled transaction is cross-border or domestic.

Specified Methods. The Regulations provide for the use of five specified methods — identical to those promulgated by the OECD Guidelines and the UN Manual — as well as for the use of an unspecified method if the taxpayer can demonstrate that none of the prescribed methods is suitable and that the unspecified method yields an arm's length result. Although the taxpayer is free to select the method based on the facts and circumstances of the transaction and no prior approval or permission with respect to method selection is required by FIRS, as the burden of proof in matters of tax controversy in Nigeria — and in many other jurisdictions including the United States — is borne by the taxpayer, leading practices dictate that CTPs should present a robust explanation of the method selection process in their transfer pricing documentation.

The specified methods include:

- Comparable Uncontrolled Price (CUP) method;
- Resale Price (RP) method;
- Cost Plus (CP) method;

- Transactions Profit Split (TPS) method, and
- Transactional Net Margin (TNM) method.

There is also latitude for FIRS to add other methods to the Regulations in the future.

As with the OECD Guidelines and the UN Transfer Pricing Manual, there is not a priority or hierarchy of methods. The Regulations direct the taxpayer to analyze each applicable transaction to determine the most appropriate method based on the relevant facts and circumstances — in particular through a "functional analysis" of the functions performed, assets employed and risks assumed by each party to the controlled transaction — as well as the availability of reliable information to apply the method and the degree of comparability between controlled and uncontrolled transactions, including the reliability of adjustments, if any, that may be required.

In applying the method selected by the taxpayer as the most appropriate, there will likely be difficulties in locating accurate and complete data for companies in Nigeria — or Africa generally — for benchmarking purposes mainly due to the dearth of publicly available data for companies in the region. Although there is no direct admonition in the Regulations for this specific issue, taxpayers should anticipate relying on data from outside Nigeria or Africa and be prepared to explain any adjustments — or lack thereof — with respect to differences in geographic markets impacting profitability.

Under the Regulations, the "tested party" — the party to the controlled transaction whose results will be tested to determine the arm's length nature of the transfer price — is not required to be the local Nigerian company. The taxpayer is free to select the most appropriate tested party given the facts and circumstances and the method selected. However, although FIRS may accept a foreign affiliate as the tested party and may also consider foreign companies as comparables, taxpayers should heed the guidance in Chapter 5 of the UN Manual which notes that, in practice, tax authorities may analyze the net profit margins of the local company as a way to identify potential audit targets. It is also important that the transfer pricing documentation appropriately explain and justify the selection of the tested party.

Advance Pricing Agreements. The Regulations provide for CTPs to enter into Advance Pricing Agreements (APAs), which are agreements made between FIRS and the taxpayer — or jointly with the Competent Authority of the taxpayer's country of residence if there is an applicable treaty providing for Mutual Agreement Procedures (MAP) — specifying the structure and pricing of one or more transactions between CTPs for a given period of time. There is no application or processing fee for an APA, but a minimum annual transaction value of NG₦250 million (approximately US$1.6 million) must be met. Generally, APAs between the FIRS and CTPs will have a term of three years unless canceled under certain circumstances by either the FIRS or the CTPs, or both.

Although APAs are often seen as conferring greater certainty in conducting cross-border transactions, because Nigeria's transfer pricing rules are so new and FIRS's administrative infrastructure lags behind that of more developed countries' tax authorities, CTPs are likely to experience frustration and delays in concluding APAs in the near term. Taxpayers and their advisors should consider these potential drawbacks carefully when contemplating pursuing an APA in Nigeria.

It is also important for taxpayers to bear in mind that, as a developing nation, Nigeria does not have a wide treaty network — having concluded less than a dozen bilateral tax treaties with other nations. Most notably, Nigeria has income tax treaties with the United Kingdom, Canada, and the Netherlands. However, there is currently no tax treaty between Nigeria and the United States. Although a stated intent of the Regulations is to reduce the risk of economic double taxation, the lack of a broad treaty network means that taxpayers will not be able to access MAP — and subsequently Competent Authority relief — in many jurisdictions.

Documentation and Compliance. Under the Regulations, taxpayers are required to prepare transfer pricing documentation prior to the due date for filing the income tax return for the year in which the documented transactions occurred. In the event of an audit by FIRS, taxpayers are required to present transfer pricing documentation to FIRS within 21 days of receiving a request. Further, the Regulations prescribe the completion and attachment of an annual declaration regarding transfer pricing — including specific statements about whether or not documentation exists—to the income tax return.

Although there is no specified form for this documentation — such as a formal report — to effectively prove up the transfer pricing positions taken by the taxpayer, reference to the OECD Guidelines and the UN Manual in the Regulations suggests that FIRS will respect documentation prepared in accordance with that guidance.

Generally, taxpayers are best advised to include in their documentation both qualitative information on the CTPs group structure and business activities, detailed descriptions of the transactions between the CTPs, and a “functional analysis” as described above, as well as quantitative analysis such as an explanation of the selection and application — including any benchmarking or other financial or economic analysis of comparable companies or transactions — of the most appropriate method to determine an arm's length result for each of the relevant transactions.

Taxpayers and their advisors should also consider the collection and maintenance of supporting documentation — such as training manuals, internal correspondence and memoranda, and travel logs of senior personnel — which may show the direct benefit received from headquarters or technical services rendered to the Nigerian operations by foreign affiliates. This additional documentation may be necessary to combat the disallowance by FIRS of otherwise appropriate inbound charges and may be especially necessary in the absence of a tax treaty.

Under the Regulations, the official language for documentation is English and FIRS may request a certified translation of non-English documentation at the taxpayer’s expense.

Retention of books and records — including ledgers, cashbooks, journals, check books, bank statements, deposit slips, invoices, stock lists, and all other germane data — is required for a period of six years from the filing of the tax return.

Materiality and Safe Harbor. Although the Regulations do not provide materiality thresholds, CTPs may be exempted from documentation requirements — but not the requirement to transact at arm's length — by FIRS when the controlled transactions are conducted in accordance with Nigerian statutory provisions or in instances where the prices have been previously approved by other Nigerian regulatory authorities. FIRS may still challenge these prices if there is a belief that they are not arm's length. Examples of other Nigerian regulatory authorities include the National Office for Technology Acquisition and Promotion (NOTAP), Nigeria Custom Services, and the Central Bank of Nigeria.

From a foreign exchange control perspective, if a transfer price approved by an agency such as NOTAP is less than the arm's length transfer price — as determined by FIRS — then the related funds may be trapped in Nigeria.

Penalties. The Regulations do not provide for a unique penalty regime for transfer pricing relying instead on the existing Acts noted above. FIRS will establish a Decision Review Panel (DRP) for the purpose of resolving any dispute or controversy arising from the application of the Regulations. A taxpayer who disagrees with the ruling of the DRP on any transfer pricing matter has recourse to the court of competent jurisdiction in the first instance — which includes the tax tribunals. Taxpayers should note that the provisions related to fraudulent filings are particularly strict in Nigeria and that to the extent a taxpayer makes a false declaration on a tax return — including indicating on the transfer pricing disclosure form that documentation is in place when it is not — FIRS may impose fines, penalties, and in some cases jail time for company officials.

Effective Date. The Regulations are effective for all tax years beginning on or after August 2, 2012. As such, calendar year taxpayers will be impacted by the new rules starting January 1, 2013. Taxpayers should be aware that although the Regulations will not apply retroactively, because the arm's length principle has always existed in the tax statutes, FIRS may challenge a taxpayer to demonstrate that transactions undertaken before the issuance of the Regulations were conducted at arm's length. Generally, FIRS can audit a taxpayer as far back as six years.

The Path Forward. While the Regulations represent a significant leap forward for FIRS, the lack of administrative infrastructure and gaps in training and sophistication between FIRS and the corporate tax functions of large multinational enterprises will likely lead to friction in the short and medium term.

While there are certainly challenges ahead, the economic opportunities in West Africa across a host of industries present exceptional potential for multinational enterprises. To best position themselves to succeed in this dynamic environment, taxpayers and their advisors should take steps to educate themselves on the Regulations, keep abreast of policy developments in the region — particularly with respect to the African Tax Administrators Forum (ATAF) and other interest groups — and conduct a review of current operations in Nigeria and Africa generally in light of the new rules. By proactively engaging competent local advisors and strategically planning and implementing new business ventures, multinational companies can create value and mitigate enterprise risk in the region.

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For more details on transfer pricing and the types of pricing methods, see Lexis Tax Advisor -- Federal Topical § 4A:18.04

For discussion of foreign and binational aspects of APAs, see 1-19 Practical Guide: U.S. Transfer Pricing § 19.03

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